



Capital One Financial Corporation
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September 30, 2011

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., NW
Washington, DC 20551
regs.comments@federalreserve.gov

Re: Regulation II interim final rule on adjustments to debit interchange transaction fees for fraud-prevention costs (Docket No. R-1404 and RIN No. 7100 AD 63)

Dear Sir or Madam:

Capital One Financial Corporation¹ ("Capital One") is pleased to submit comments to the Federal Reserve Board ("Board") on its interim final rule governing adjustments to debit interchange transaction fees for fraud-prevention costs ("Interim Rule").² The Interim Rule permits an issuer to receive an adjustment of 1 cent to its interchange transaction fee if the issuer meets certain non-prescriptive requirements.³ We support the non-prescriptive approach adopted in the Interim Rule, but believe that the 1 cent amount should be adjusted upwards to better reflect the true costs of fraud prevention and avoid stifling innovation and progress in this important area.

Capital One has participated in the drafting of and strongly supports the positions expressed in the joint comment letter filed by the American Bankers Association, the Clearing House Association, the Consumer Bankers Association, the Credit Union National Association, the Financial Services Roundtable, the Independent Community Bankers of America, the National Association of Federal Credit Unions, the Midsize

¹ Capital One Financial Corporation (www.capitalone.com) is a financial holding company whose subsidiaries, which include Capital One, N.A. and Capital One Bank (USA), N. A., had \$126.1 billion in deposits and \$199.8 billion in total assets outstanding as of June 30, 2011. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients. Capital One, N.A. has approximately 1,000 branch locations primarily in New York, New Jersey, Texas, Louisiana, Maryland, Virginia and the District of Columbia. A Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol "COF" and is included in the S&P 100 index.

² 76 Fed. Reg. 43478 (July 20, 2011).

³ Interim Rule, 12 C.F.R. § 235.4(b).

Bank Coalition of America, and the National Bankers Association (“Association Letter”). Given the significance of this topic, however, we thought it important to submit our own letter.

* * *

Fraud Prevention Benefits Consumers, Merchants, Banks, and Society.

As we noted in our February 22, 2011 comment letter on the Federal Reserve’s proposed rule for the general regulation of debit card interchange fees (“Proposed Rule”),⁴ debit cards are a valued payment mechanism both for consumers and those 8 million merchant locations that accept debit cards in the United States.⁵

The benefits of debit card transactions are numerous, including:

- ubiquity of acceptance;
- ease, safety and security of consumer access to deposit accounts, freeing consumers from the risk and inconvenience of carrying cash;
- fraud protection under clear rules for both consumers and merchants;
- increased speed at checkout;
- facilitation of internet and telephone transactions; and
- availability of an inexpensive and effective payment mechanism for consumers who do not qualify for or wish to use credit cards.

Effective fraud prevention is critical to enabling many of these important benefits. Debit card fraud harms all participants in the debit card payment system. Even with limited liability under network rules and Regulation E,⁶ debit card fraud harms consumers, since they are required to spend valuable time obtaining refunds for fraudulent charges and handling card re-issuances after fraud incidents. Merchants also are worse off because they bear some liability for fraud losses through the chargeback process. Card networks and the debit card industry generally are harmed by debit card fraud to the extent that fraud causes consumers to have less confidence in the debit card system and use other forms of payment in lieu of debit cards. Finally, fraud can be a common way for organized crime networks to fund their various operations. If fraud is not aggressively prevented by issuers, crime networks may have a greater chance of success.

As the Board recognizes, there are significant costs to the issuer banks for fraud prevention, costs which provide value to both consumers and merchants.⁷ In 2009 alone, issuers absorbed approximately \$830.8 million in actual fraud losses related to debit card transactions.⁸ Losses for issuers and merchants alike were also reduced by the substantial

⁴ Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81722 (proposed Dec. 28, 2010).

⁵ 75 Fed. Reg. at 81723.

⁶ See 12 C.F.R. § 205.6.

⁷ The Board acknowledges that according to its survey data, the majority of reported fraud losses were borne by issuers rather than merchants, and that the fraud losses borne by cardholders are negligible. 75 Fed. Reg. at 81741.

⁸ See 76 Fed. Reg. at 43480-81.

investments that issuers made to deter fraudulent transactions from occurring in the first place.

The Interim Rule Appropriately Adopts a Flexible, Non-Prescriptive Approach for the Fraud Prevention Adjustment.

Section 920(a)(5) of the Durbin Amendment authorizes the Board to adjust the general permitted interchange fee so that issuers may recover their fraud prevention costs. We believe that the Interim Rule correctly requires issuers who wish to receive a fraud prevention adjustment to meet flexible, non-prescriptive fraud prevention standards. This approach is consistent with the Board's technology-neutral approach taken in other contexts⁹ and is more readily administered and enforced than a technology-specific approach. In addition, the approach allows each issuer to tailor its fraud prevention program based upon the nature and scope of its actual debit card practices and provides both the Board and issuers with the flexibility to adapt with changes in technology, as well as changes in fraud activities and techniques.

As the Board recognizes, a technology-specific approach is problematic because it would cause issuers to under-invest in other technologies¹⁰ and therefore put the Board in the position of choosing winners and losers among fraud prevention techniques. Issuers with direct experience with debit card fraud are best suited to identify the most effective fraud prevention techniques. We also note that regulatory reviews of emerging fraud defenses, in order to obtain the designation required for reimbursement under Regulation II, would slow the implementation of potentially salutary defenses and, therefore, could disadvantage banks and consumers alike. This process is likely to be self-defeating as sophisticated perpetrators of fraud would receive advance warning of the technologies to be deployed and would have a head start at circumventing them.

The Interim Rule also appropriately applies the adjustment amount to all debit card transactions, regardless of authentication method. We strongly agree with the Association Letter's discussion of this issue. In particular, we do not believe that issuers should generally be required to encourage cardholders to use certain authentication methods over others. First, certain transaction methods, such as PIN, cannot currently be used for telephone and internet transactions. And many point-of-sale merchants choose not to accept PIN transactions. Finally, and perhaps most importantly, encouraging cardholders to use certain authorization methods does not appear likely to result in lower fraud losses. Encouraging cardholders authorized to make transactions on the card to use certain authorization methods will not influence the behavior of a criminal who makes fraudulent transactions with the debit card. As long as alternatives to, for example, PIN transactions remain available to fraudsters, fraudsters will take advantage of that means.

⁹ See, e.g., information security standards issued by the Board and other federal banking agencies to implement section 501(b) of the Gramm-Leach-Bliley Act.

¹⁰ 75 Fed. Reg. at 81742.

The Interim Rule is a Good Starting Point, but Should be Adjusted Upwards to Cover the True Costs that Issuers Bear for Fraud Prevention.

Although we generally support the concepts in the Interim Rule, it should be amended in final form to take into account the full costs of fraud prevention. The 1 cent amount in the Interim Rule does not reflect the true costs of fraud prevention and risks stifling innovation in fraud prevention over time.

As an initial matter, the Board derived the fraud prevention adjustment from the median amount spent by surveyed issuers on fraud prevention,¹¹ which means that half the issuers surveyed spend more than 1 cent per transaction on fraud prevention (excluding monitoring) and would not be reimbursed for their costs under the Interim Rule. The Board made no findings to suggest that spending more than 1 cent per transaction on fraud prevention is unreasonable. Any cap should therefore be placed at a higher level than median costs (*i.e.*, at the 80th percentile level), to permit a greater portion of issuers to be reimbursed for their fraud prevention costs and to encourage those below that level to increase their level of investment.¹²

The Interim Rule also appears to exclude costs associated with (i) responding to customer inquiries concerning fraudulent or potentially fraudulent activity and (ii) researching and developing new technologies and methods of fraud prevention. Responding to customer inquiries is often the starting point for uncovering fraud and thereby prevents fraud by stopping the criminals from committing even further fraud. Indeed, Regulation E acknowledges the importance of cardholder inquiries to fraud prevention.¹³ Likewise, research and development is essential to combating fraud and is critical in making fraud prevention investment decisions. Although not all research, tests, and pilots for new technology and systems will ultimately be adopted, the knowledge and insight gained from that research inform and advance the techniques that are adopted and the general goal of preventing fraud.

It is incumbent upon the Board both as a policy matter and statutory matter under the Electronic Fund Transfer Act to promulgate rules that, while consistent with the statute, avoid undue disruption to consumers and the debit card marketplace. Fraud prevention is a dynamic field in which fraud schemes constantly evolve. Issuers must continuously invest in new strategies and technologies to protect themselves, merchants, and consumers. A fraud adjustment price cap is by its very nature inconsistent with the goal of an innovative and secure payment system. Careful attention must therefore be given not to set the fraud adjustment level too low so that it unnecessarily stifles innovation and progress. The Interim Rule constitutes a factor against investing more than 1 cent per transaction for fraud prevention, and, consequently, risks greater fraud losses going

¹¹ 76 Fed. Reg. at 43481-83.

¹² Using the 80th percentile of issuer costs would be consistent with the approach used by the Board when determining the general debit interchange fee cap. 76 Fed. Reg. at 43422.

¹³ As the Board is aware, Regulation E provides for increases in a cardholder's liability for fraud losses related to the card if the cardholder fails to report stolen debit cards in a timely manner. *See, e.g.*, 12 C.F.R. § 205.6(b).

forward. The 1 cent cap also acts as a disincentive for issuers to develop and apply new technologies that require significant costs upfront but have the potential for substantial long-term reductions in fraud losses, because there is no guarantee that the Board will later revise the adjustment amount or permit compensation for past expenditures. Indeed, if fraud prevention costs rise sharply, issuers will not recoup any amount above 1 cent per transaction for the two-year time period before the Board conducts a new survey of issuer costs and potentially revises the fraud prevention amount to account for the increased costs.

Accordingly, we urge the Board to revise upwards the 1 cent amount to ensure that it covers all reasonable costs that issuers incur for fraud prevention and rewards issuers for investing in new technologies and methods of combating fraud.

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Capital One appreciates the opportunity to comment on the Board's Interim Rule. If you would like to discuss our comments, please call me at 703-720-1000, or Candace Davis, Associate General Counsel, Regulatory, at 703-720-2253.

Sincerely,



Andres L. Navarrete
Senior Vice President
Chief Counsel – Card, Regulatory, and
Enterprise Governance